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BANKING ALERT

An Update for Banking Clients of Simon Galasso & Frantz, PLC

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The Importance of Good Loan Documentation—or How to Lose Your Collateral in One Easy Step

By David Morrow and Gladys Goschka

A recent case illustrates the perils of poor loan documentation. Do your procedures measure up?

The importance of good loan documentation is apparent to risk management professionals, credit officers and workout specialists. In large corporate transactions, no one questions the need for complete documentation custom drafted by experienced legal professionals. In the middle-market, however, too many times loan officers view documentation as an impediment to closing or an unnecessary expense to be minimized as a way to compete with other lenders. A recent case in western Michigan demonstrates the risks inherent in such an attitude.¹

When an auto auction borrower defaulted on its \$1.5 million loan, the individual owner offered to guarantee the loan and mortgage his principal residence in return for the lender's agreement to forbear. His spouse joined in the mortgage, but not in the forbearance agreement. The mortgage, undoubtedly a form document, identified the mortgagor as the husband and the wife, and stated that it secured the payment of \$1,500,000 "according to a Note of even date herewith." Unfortunately for the lender, no such note was executed. Rather, the mortgage should have referred to the original note and the forbearance agreement.

In Michigan, a widow has dower rights in real property owned by her husband during the marriage. A right of

dower vests upon the death of the husband, and is a widow's right, during her lifetime, to use one-third part of her deceased husband's lands. Dower cannot be compromised without the wife's consent, and no act of the husband can prejudice this right.

In this case, the plaintiff wife alleged that she did not intend to secure her husband's individual debts, but only their joint debts. Although originally ruling for the lender, on reconsideration the trial court held for the plaintiff, finding that the mortgage secured a non-existent obligation. Because the husband signed the promissory note and forbearance agreement in his individual capacity, as opposed to the legal entity of husband and wife, the trial court determined that neither was secured by the mortgage.

The Michigan Court of Appeals reversed, holding that the intent of the parties should govern, and although the mortgage described a note signed earlier that day, it was clear that the parties were referencing the forbearance agreement. Accordingly, the Court of Appeals determined that the wife's dower right was subordinate to that of the lender's interest under the mortgage.

Although the lender prevailed in this case, consider the time and expense involved in trying a case before a district court and pursuing an appeal to the Michigan Court of Appeals. If the plaintiff exercises her right to appeal, additional time and expense could be involved. All of this could have been avoided had someone given some thought to how the form mortgage should have been completed and whether it correctly described the actual transaction. Too often we see form documents with blanks not completed or completed without an understanding of the legal implications involved.

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¹ Although a client was involved, Simon, Galasso & Frantz, PLC had no part in the documentation, workout, or litigation relating to this transaction. For a copy of the opinion, point your browser to: <http://www.michbar.org/opinions/home.html?opinions/appeals/2003/091103/20262.pdf>

Dower and homestead rights have been a trap for the unwary lender in Michigan for many years. To avoid an unpleasant surprise, we suggest verifying the marital status of any individual granting you a mortgage. If the individual is married, make sure the spouse joins in the mortgage or signs a waiver of dower and homestead rights. Finally, make certain the mortgage correctly describes the obligation being secured.

At Simon, Galasso & Frantz, PLC, we take loan documentation seriously, and insure that experienced professionals make the critical decisions that make a difference

when the documents must be enforced in workout negotiations, bankruptcy or in litigation. By the same token, we recognize that documents cannot cover all possible contingencies, and over-papering a small business or middle market loan with lengthy documents and generating large legal fees will drive away customers faster than non-competitive rates.

Should you have a question relating to structuring or documenting your next loan transaction, please call Frank Simon or one of the other legal professionals at Simon, Galasso & Frantz, PLC.



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